THE ENDANGERED US DOLLAR

The US dollar may be due for a collapse if the OPEC oil-producing nations decide to sell oil for euros instead of dollars, or if the "mortgage bubble" bursts the US economy from within.

by Richard Heinberg © 2004

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> *To preserve our independence, we must not let our rulers load us with perpetual debt. We must make our election between economy and liberty, or profusion and servitude.*
>
> — Thomas Jefferson

A Brief History of Money

For decades, the US dollar has served as the world's default currency. The phrase "sound as a dollar" has expressed the faith and confidence of generations of not only Americans but people worldwide. That situation is coming to end, and the consequences will be far-reaching.

In order to understand why this sea change is about to occur, and what is at stake, it is necessary to begin by examining in the briefest terms the history of money, banking and the dollar.

Hunter-gatherer societies typically enjoyed a gift economy in which trade and barter occurred only with people external to the tribe or band. Everyone within the band was treated as family: whatever was available was shared without expectation of reciprocal exchange.

The story of the rise of social complexity is also the story of the gradual shrivelling of the gift economy and the expansion of the scope of trade—a story that culminates in our situation today in which the market mediates nearly all categories of transactions between and among humans, sometimes even within families.

Even many relatively complex societies of the past (such as the ancient Egyptian and Incan civilisations) managed to do without money. However, this new tool, wherever it appeared, served to facilitate and accelerate trade. Its effects were predictable; French Historian Fernand Braudel, writing of Europe in the Middle Ages, described them as "steep variations in prices of essential foodstuffs; incomprehensible relationships in which man no longer recognised himself, his customs or his ancient values". The individual caught up in mediaeval Europe's monetisation process found, again in Braudel's words, that "his work became a commodity, himself a 'thing'".

The kinds of money people have used are almost endless; however, in societies that have adopted the widespread use of money, coins made of precious metals long ago became favoured over other options (including shells, beads, cattle and, in China, paper) due to their relative durability, portability and rarity. Since money serves several possible functions—a store of value, a measure of value, a medium of exchange and a standard of deferred payment—in some cases individual societies have used two or more forms of money simultaneously.

Monetary history took a decisive turn with the emergence of banking in Europe during the Middle Ages. Since travelling traders were frequently robbed of their coins or metal ingots, they took to depositing their metallic currency in the strongboxes of silversmiths and goldsmiths, and carried redeemable receipts instead. Gradually these receipts came to be regarded as being equivalent to the metal itself. This was the first paper money.

Meanwhile, goldsmiths and silversmiths discovered that it was possible to issue receipts for metal coins which they did not actually possess—a practice that would eventually give rise to fiat currencies and fractional reserve banking.

Fiat currencies did not appear in the West in any significant quantity until the 19th century, when governments and national banks began issuing notes not backed by any precious metal coinage whatever.

Fractional reserve banking emerged at about the same time as a system whereby banks were legally permitted to lend more money than they retained in deposits (regardless of whether those deposits were in the form of gold or fiat money). This process seems mysterious and perhaps even a tad unethical to most people when they initially learn of it. However, it has become the foundation of modern banking and currency systems.

In effect, when a commercial bank makes a loan, it creates money from nothing. When the loan is repaid and is struck from the books, that money effectively disappears. Since it has been lent into existence, virtually all fiat currency in modern money economies is tied to debt, which requires the payment of interest.

The regulation of the money supply therefore depends on someone's ability to set interest rates and thus encourage or discourage the seeking of more loans.

Early Life of the US Dollar

From this point on, we will focus our attention on a particular currency: the US dollar.

During the Revolutionary War the provisional authorities issued paper money, which led to counterfeiting by the British and to various other forms of fraud.

The 1792 US Coinage Act provided for a national Mint where silver dollars were to be produced along with gold coins, beginning in 1794. The Act states: "The Dollar or Unit shall be of the value of a Spanish milled dollar as the same is now current, to wit, three hundred and seventy-one and one-quarter grains of silver." The Act also prescribed the death penalty for anyone debasing the national currency.

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The framers of the American Constitution were divided on the question of whether their new nation should have a national bank. Proponents (who were themselves bankers or future bankers) argued that a national bank would be necessary for the proper regulation of a national currency; opponents argued that such an institution would effectively give a tiny banking elite control of the nation's economy. The opponents won: Article I of the US Constitution gave Congress the power to coin money.

However, the proponents of a national bank, led by Alexander Hamilton, did not give up. At the time, local banks issued other currencies in addition to the fledgling national currency. The nation needed a single currency and a way of financing the government. All of the government's financial needs, said the Hamiltonians, should be underwritten by funds borrowed from the national bank and repaid by the government with funds raised by taxation from the people. Thomas Jefferson led the opposition.

Twice in the 19th century a national bank was established (in 1791 and 1817), and twice abolished (the first time in 1811, the second in 1832, both times on charges that the bank was corrupt and unconstitutional). Further attempts were made to establish a national bank until the early years of the 20th century, but these were rejected on constitutional grounds.

The nation's money, controlled by the government, was sometimes a fiat paper currency and sometimes backed by gold or silver. Periods of inflation or deflation led to depressions. Private banks continued to issue their own banknotes as currency until the end of the Civil War, during which Lincoln floated millions of dollars in fiat "greenbacks" in order to finance the army. In 1878, Congress began to redeem greenbacks for gold, which effectively put the US back on the gold standard until 1933.

In general, the Republicans were married to gold, while Populists, Democrats and the "Greenback Party" promoted silver and/or the printing of lots of paper money. They argued that gold had become concentrated in the hands of the bankers; if money were to get into the hands of "real people", the government would have to issue more fiat or silver-backed paper notes. The monetary question split the nation for decades.

Clearly, gold as money acts as a barrier to the expansion of credit money. This can be both good and bad: it prevents hyperinflation, but it can also put a brake on economic activity, leading in the worst instances to deflation and depression. In 1896, the conflict came to a head as Populist William Jennings Bryan ran against pro-gold Republican William McKinley. Though McKinley won, gold's time had passed.

Following the Depression of 1907, Congress passed the Owen–Glass Federal Reserve Act of 1913, which established the national banking cartel that controls the nation's currency to this day. The Federal Reserve (known colloquially as "the Fed") is a peculiar hybrid government–private institution whose chairman is appointed by the US President but whose stock is entirely owned by member banks. In effect, the Fed is a private corporation owned by the interests that it nominally regulates on behalf of the people.

After the Fed's establishment, the government quickly recalled its Treasury Notes and the Fed began issuing Federal Reserve Notes with a promise to redeem them for gold upon demand. Congress also handed the Fed control of the nation's gold. The Fed then began lending back the gold, at interest.

The Fed's tools for controlling the economy are few but powerful. It sets the rules for member banks for fractional reserve banking (money creation) and sets the discount rate (the rate of interest charged to member banks for the privilege of creating money). When the federal government wishes to take out a loan to pay for a new bomber or highway, it effectively borrows the money from the Fed (though the debt usually then gets spread around to various domestic and foreign investors), which thus controls not only the nation's monetary system but government credit as well. The benefits issuing from the flow of insider information that results from that control are unknown but surely considerable. The Fed's deliberations occur in secret and the institution has never been audited.

Even after the Fed's creation, several kinds of currency existed from time to time during the early 20th century, including United States Notes, Gold Certificates and Silver Certificates. But, from about 1965 to the present, virtually all US currency has consisted of Federal Reserve Notes—i.e., money created not by the government (which merely prints the paper notes themselves, which it sells to the Fed for the cost of printing), but by the Federal Reserve and its member banks.

On March 9, 1933, at the deepest point of the Great Depression, Franklin Roosevelt issued Executive Orders 6073, 6102, 6111 and 6260, effectively declaring the US bankrupt. On April 5, 1933, Roosevelt declared a National Emergency that made it unlawful for any citizen of the United States to own gold, and ordered all gold coins, gold bullion and gold certificates turned in to Federal Reserve banks by May 1 under the threat of fines and imprisonment. On

June 5, 1933, Congress enacted a joint resolution outlawing all gold clauses in contracts.

Henceforth, for the next 40 years in the US, a dual monetary system would prevail which denied gold redeemability to Americans while retaining it for foreigners.

The Dollar Triumphant

This brings us to the story of the dollar's rise to international prominence.

Prior to World War II, the British pound sterling came close to being a globally accepted standard currency, largely as a result of the fact that it was issued by an Empire upon which the Sun never set. However, neither the Empire nor the British economy survived the war intact. The US economy, meanwhile, though having been hammered by the Depression, emerged from World War II more robust than ever.

A postwar economic and geopolitical regime gradually emerged during the years 1944 to 1948. Postwar geopolitics would consist of a long political Cold War (which was also an economic war between the US and the USSR, itself a major oil producer and goods exporter within its sphere); meanwhile, the non-Soviet-dominated global economy would be shaped in agreements settled on at international meetings held in Bretton Woods, New Hampshire.

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The chief feature of the Bretton Woods system consisted of the obligation for each country to maintain the exchange rate of its currency within a fixed range—plus or minus 1%—in terms of gold. This well suited the United States, which at the time happened to have the largest gold reserves of any nation.

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The arrangement worked reasonably for all concerned, as long as America remained the world's foremost energy producer and goods exporter—which permitted it, in turn, to maintain its gold reserves. The US extended dollar credits by way of the Marshall Plan to finance the rebuilding of postwar Europe, while American oil companies (and the Texas Railroad Commission) maintained stable prices for petroleum globally.

During this period, US foreign policy and domestic policy were characterised by liberalism: at home, economic inequality was at the lowest point in modern American history; while abroad, the United States maintained minimal trade barriers between itself and Western Europe, Japan and South Korea. It could easily afford to absorb exports from these nations in return for their commitment of support for the duration of the Cold War.

The US exercised leadership by consensus—again, because it could easily afford to do so. This consensus evolved through both GATT trade negotiations and geostrategic Bilderberg meetings, in which the main Western powers conspired to effectively control the economies and political destinies of most of the rest of the world's nations.

However, this first relatively benign phase of what Henry Luce called "the American Century" came to an end as a result of the confluence of three factors: the decline of US oil production, spiralling national debt brought on by the Vietnam War, and increasing European and Japanese economic strength.

1973–1999: The Petrodollar Era

The members of the US-dominated consensus, while agreeing to cooperate, still had their own interests at heart and sought advantages wherever possible. F. William Engdahl, in an essay in *Current Concerns* titled "Iraq and the Hidden Euro-Dollar Wars" (http://www.currentconcerns.ch/archive/2003/04/20030409.php), describes the subsequent unravelling:

"All during the 1960s, France's de Gaulle began to take...dollar export earnings and demand gold from the US Federal Reserve, legal under Bretton Woods at that time. By November 1967 the drain of gold from US and Bank of England vaults had become critical. The weak link in the Bretton Woods Gold Exchange arrangement was Britain, the 'sick man of Europe'. The link broke as Sterling was devalued in 1967. That merely accelerated the pressure on the US dollar, as French and other central banks increased their call for US gold in exchange for their dollar reserves. They calculated that, with the soaring war deficits from Vietnam, it was only a matter of months before the United States itself would be forced to devalue against gold, so better to get their gold out at a high price."

By May 1971, even the Bank of England was demanding gold for dollars, and the drain on US reserves had become intolerable. Nixon did the only thing he could under the circumstances: he abandoned the Gold Exchange program altogether, and in August of that year a system of floating currencies was instituted. Engdahl again:

"The break with gold opened the door to an entirely new phase of the American Century. In this new phase, control over monetary policy was, in effect, privatized, with large international banks such as Citibank, Chase Manhattan or Barclays Bank assuming the role that central banks had in a gold system, but entirely without gold. 'Market forces' now could determine the dollar. And they did with a vengeance."

In 1973, with the dollar now floating freely, the Arab nations of OPEC embargoed oil exports to the US in retaliation for American support for Israel in the Ramadan/Yom Kippur War. By this time it was clear that US oil production had peaked and was in permanent decline, and that America would become ever more dependent upon petroleum imports. As oil prices soared 400%, the US economy took a nosedive.

The US and Saudi Arabia had formed a cooperative partnership in 1945, following meetings between FDR and King Ibn Saud. US oil companies (Exxon, Mobil, Chevron, and Texaco) were already controlling Saudi discovery and production through a partnership with the Kingdom, the Saudi Arabian Oil Company (Aramco). In 1973, the Saudi government increased its partner's share in the company to 25%, and then 60% the next year. In 1980, the Saudi government retroactively gained full ownership of Aramco with financial effect as of 1976.

In 1975, the Saudis agreed to export their oil for US dollars exclusively. Soon OPEC as a whole adopted the rule. As a result, the dollar was backed not by gold but in effect by oil. Had the US permitted the Saudis to nationalise their oil industry in return for this extraordinary favour? Because the Saudi royal family and the oil companies are all notoriously tight-lipped, we may never know.

In any case, the oil shock created enormously increased demand for the floating dollar. Oil importing countries, including Germany and Japan, were faced with the problem of how to earn or borrow dollars with which to pay their ballooning fuel bills. Meanwhile,

OPEC oil countries were inundated with oil dollars. Many of these oil dollars ended up in accounts in London and New York banks, where a new process—which Henry Kissinger dubbed "recycling petrodollars"—was instituted.

The process worked like this. OPEC countries were receiving billions of dollars they could not immediately use. When American and British banks took these dollars in deposit, they were thereby presented with the opportunity for writing more loans (banks make their profits primarily from loans, but they can only write loans if they have deposits to cover a certain percentage of the loan—usually 10% to 15%, depending on the current fractional reserve requirements issued by the Fed or Bank of England). Since the economies of industrialised nations were in no position to take on much new debt, the banks were faced with a problem: to whom could they lend a boatload of new petrodollar-based money? Kissinger, an adviser to David Rockefeller of Chase Manhattan Bank, suggested the bankers use OPEC dollars as a reserve base upon which to aggressively "sell" bonds or loans, not to US or UK corporations and investors but to Third World countries desperate to borrow dollars with which to pay for oil imports.

By the late 1970s, these petrodollar debts had laid the basis for the Third World debt crisis of the 1980s (after interest rates exploded). Most of that debt is still in place and is still strangling many of the poorer nations. Hundreds of billions of dollars were recycled in this fashion. (Incidentally, the borrowed money usually found its way back to Western corporations or banks in any event, either by way of contracts with Western construction companies or simple theft on the part of indigenous officials with foreign bank accounts.)

Also during the 1970s and 1980s, the Saudis began using their petrodollar surpluses to buy huge inventories of unusable weaponry from US arms manufacturers. This was a hidden subsidy to the US economy and especially to the so-called Defense Department.

As Engdahl points out, the petrodollar era was characterised by the US attempt to slow its geopolitical decline (arising from imperial overextension abroad and resource depletion at home) by making the dollar an hegemonic currency:

"The IMF 'Washington Consensus' was developed to enforce draconian debt collection on Third World countries, to force them to repay dollar debts, prevent any economic independence from the nations of the South, and keep the US banks and the dollar afloat. The Trilateral Commission was created by David Rockefeller and others in 1973 in order to take account of the recent emergence of Japan as an industrial giant and try to bring Japan into the system. Japan, as a major industrial nation, was a major importer of oil. Japanese trade surpluses from export of cars and other goods were used to buy oil in dollars. The remaining surplus was invested in US Treasury bonds to earn interest. The G-7 was founded to keep Japan and Western Europe inside the US dollar system. From time to time into the 1980s, various voices in Japan would call for three currencies—the dollar, German mark and yen—to share the world reserve role. It never happened. The dollar remained dominant."

Simultaneously during the 1980s, the US effectively bankrupted the Soviet Union by forcing the Soviets to pump their oil reserves at the maximum rate in order to pay for the escalating arms race with America and the US-fomented Afghan war, while reducing oil income to the Soviets by asking the Saudis to keep world oil prices low. As foreseen by the CIA, Soviet oil production peaked; and, as it declined, the nation's economy imploded. The Cold War had been won.

The petrodollar era had worked to the American financial elite's advantage, but at an horrendous cost to the people of the Third World and to those of the former Soviet Union as well. Living standards declined in all of these countries as IMF "structural adjustment" policies opened markets to the predatory process of globalisation led by US-based multinationals seeking cheap labour and raw materials. The people of the US suffered also, as America's manufacturing base was "hollowed out" through outsourcing. While a quarter-century previously 60% of the world's export goods had carried a "Made in USA" label, now American companies were interested primarily in "branding" products made in China or Central America. Jobs for US workers were consequently downsized.

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During the petrodollar era, American foreign economic policy and military policy continued to be dominated by the voices of the traditional liberal consensus, which required that the US act in concert with its allies. But this was about to change.

1999 to Present: Hegemonic Decline, Imperial Hubris

As the Cold War ended, Europe was in the process of forging political and economic unity. Today the European Union and the euro—an entirely new pan-European currency—present a subtle but serious threat to continued American monetary hegemony. This challenge has developed slowly over the past 15 years, but its effects are cascading into view. In the US/UK invasion and occupation of Iraq we see the dynamics of this new challenge at play, including the American response to it. The Washington neo-conservatives have a term for this response: "democratic imperialism".

As Jeremy Rifkin documents in his new book, *European Dream: How Europe's Vision of the Future is Quietly Eclipsing the American Dream*, Europe is ever less a collection of squabbling nations and ever more a cohesive economic superpower—one that exceeds the US in GDP, population and productivity. Europe shares America's dependency on depleting foreign sources of oil and gas, and will likely be hit hard by the effects of global climate change. Thus, over the long term, Europe's prospects are dim—though no dimmer necessarily than those of any other region.

However, in the short term, Europeans will enjoy some advantages over their American counterparts, including much greater energy efficiency (Europeans use energy at one-half the per-capita rate as Americans) and much less debt, resulting partly from much smaller military budgets. Moreover, Europe sits next to Russia, which still has considerable quantities of exportable oil and gas and stockpiles of nuclear and conventional weapons.

A Eurasian alliance between Russia, Germany and France would be a geopolitical nightmare for Washington—and such an alliance is beginning quietly and tentatively to emerge. Europe is also geographically closer to the oil and gas reserves of the Middle East and

Central Asia, which are increasingly accessible to it by pipeline (the United States must rely on tankers).

The development of this Eurasian challenge comes at a bad time for Washington, which is in no position to offer the kinds of trade concessions it did in earlier decades in order to maintain the G-7 consensus. America's only remaining strong suit is raw military power, and thus it has two options: to decline gracefully from its position as sole superpower, or to use its military to enforce global dominance.

Engdahl suggests that the neo-conservatives gained influence in Washington because a majority in the US power establishment finds their views useful to advance a new aggressive US role in the world. Rather than work out areas of agreement with European partners, Washington increasingly sees Euroland as the major strategic threat to American hegemony, especially the "Old Europe" of Germany and France. Just as Britain in decline after 1870 resorted to increasingly desperate imperial wars in South Africa and elsewhere, so the United States is using its military might to try to advance what it no longer can by economic means. Here the dollar is the Achilles heel.

To understand why the dollar is America's Achilles heel, a metaphor is useful. Imagine being able to write checks [cheques] and then convince the people you give them to *not to cash them*. Perhaps they find the checks themselves comforting to hold onto; or maybe you have a friend who agrees to sell groceries or gasoline for *your checks only*, and then happily stockpiles and recirculates them. In either case, you may be tempted to write checks for much more than you have in your bank account. As long as the checks themselves are regarded as valuable and are not cashed, you get a free ride.

America's only remaining strong suit is raw military power, and thus it has two options: to decline gracefully from its position as sole superpower, or to use its military to enforce global dominance.

But if people stop finding your checks comforting to hold onto, or if your friend starts selling groceries for other people's checks or for gold or silver, then the game is up. It will be revealed that your account is overdrawn and you will be in trouble.

The metaphor is not perfect. In fact, every nation in the world is attempting to write checks beyond its means. But the US has managed to do by far a better job of it than any other nation. The checks we are not talking about are not just hoarded paper dollars (though there are billions of these stuffed in mattresses around the world) but dollar-denominated investments and securities, including T-bills, stocks and mortgages. Currently the US is running a $700 billion per year trade deficit—this on top of trillions in government debt and trillions more in consumer debt. No other nation in the world comes remotely close to this level of bad-check writing, on either a total or a per-capita basis.

If a run on the US dollar were to occur, then the only financial solution would be to create even more dollars (presumably through government borrowing), which of course wouldn't actually solve the problem and would in the long run make matters worse. The currency would become almost worthless, and in the process real wealth (land, factories and natural resources) would be confiscated and turned over to creditors.

What could cause this to happen? A decision by OPEC to sell oil openly for euros could be a trigger. Some oil is already quietly being sold for euros, and several countries including Iran and Saudi Arabia have floated the possibility of valuing oil against a basket of currencies (meaning, effectively, dollars *and* euros). The Arab OPEC states have toyed with an idea that must be equally worrisome to Brussels and Washington: to sell oil for gold (the gold dinar). If and when this happens, the full wrath of America will descend upon the Arab Middle East—and that's why it hasn't happened yet.

The other likely trigger would be a collapse of the US economy from within, resulting from a bursting of the mortgage bubble. The recent US economic "recovery" arose almost entirely from low mortgage rates (set ultimately by the Fed), which allowed families to refinance their homes, cash out some of their equity and use the money for immediate consumption. With oil prices soaring, the Fed will eventually have to raise interest rates steeply in order to contain inflation. But this may cause millions of home owners to default on their currently low-interest, adjustable-rate mortgages. In that event, property values would plummet, and with them would go the stock-market and the economy as a whole.

If the Fed's real owners are confident in the present Washington leadership, they will do everything in their power to delay the inevitable until after the election (and this is what they seem to be doing). If they think it is time for a regime change, we may see the great unravelling begin even before November.

In either case, the response of US political leaders may be merely to seek foreign scapegoats. As Stan Goff writes in his recent essay, "Persian Peril" (see the website http://www.fromthewilderness.com), it appears as if Iran is currently being set up as the next domino in the neo-cons' crusade for democracy in the Middle East. With Iranian and Russian cooperative energy agreements blooming, a US attack on Iran could be the trigger for another all-out conflict on the scale of the World Wars of the 20th century.

On the other hand, it is possible that the disastrous outcome of the Iraq invasion has sunk deeply enough into the awareness of Washington elites that further similar adventures (however desperately sought by the neo-cons) will be headed off by cooler minds.

How Can We Respond?

There is no solution to any of this—in that there is nothing we can do to make the problems go away. Their origins go far back in time and are intertwined with the history of money itself, though money *per se* is not at the heart of the matter. Access to resources is, as ever, the ultimate determiner of human destiny, but money has become a tool universally used by humans to gain and hold access to resources and as such it introduces its own set of possibilities and perils.

While there is no solution, there must be responses, and some are better than others. The relocalisation of economies (moving producers and consumers closer together) and currencies are good places to start.

About the Author:

Richard Heinberg is the author of six books including *The Party's Over: Oil, War and the Fate of Industrial Societies* (New Society, 2003; reviewed in NEXUS 10/01), and *Powerdown: Options and Actions for a Post-Carbon World* (New Society, 2004). He is a journalist and lecturer, an educator and editor, and also a core faculty member of New College of California where he teaches a program on "Culture, Ecology and Sustainable Community". His monthly *MuseLetter*, now in its 13th year of publication, was nominated in 1994 for an Alternative Press Award. His article in this issue, "The Endangered US Dollar", was first published in *MuseLetter* #149, August 2004. Visit the *MuseLetter* website at http://www.museletter.com.